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No. 81-523

IN THE

Supreme Court of the United States

October Term, 1981

CONTAINER CORPORATION OF AMERICA,

Appellant,

vs.

FRANCHISE TAX BOARD,

Appellee.

On Appeal from the Court of Appeal of the State of California for the First Appellate District.

BRIEF OF AMICUS CURIAE ON THE MERITS IN SUPPORT OF APPELLANT, SUBMITTED ON BEHALF OF THE FIRESTONE TIRE & RUBBER COMPANY.

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BRIEF OF AMICUS CURIAE ON THE MERITS IN SUPPORT OF APPELLANT, SUBMITTED ON BEHALF OF THE FIRESTONE TIRE & RUBBER COMPANY.

Introductory Statement.

This brief is submitted by The Firestone Tire & Rubber Company as *Amicus Curiae* in support of the appellant in the above-captioned case. Written consents of both appellant Container Corporation of America and appellee Franchise Tax Board are on file with the clerk of this Court.

Interest of Amicus Curiae.

Amicus, The Firestone Tire & Rubber Company ("Firestone"), whose corporate headquarters are at Akron, Ohio, the state of its incorporation, does business throughout the United States. It manufactures and sells "Firestone" — branded tires and other rubber-oriented products. Like Container Corporation of America ("Container"), Firestone too has been assessed deficiencies in tax by the State of California, on the basis of a worldwide combined report, wherein the three-factor formula of property, payroll and

sales has been applied to a tax base consisting of the combined incomes of Firestone and twenty-two foreign subsidiaries incorporated and doing business entirely outside the United States.

The constitutional validity of worldwide combined reporting is the subject of an appeal presently pending in the California Court of Appeal for the Second Appellate District (Los Angeles) in which Firestone is a party, involving income years 1960 through 1963. The primary issue in said appeal, known as *Firestone v. Franchise Tax Board* (2d Civil 62918), is whether California may constitutionally require Firestone to file its state franchise tax returns on a combined report basis with its twenty-two majority-owned foreign subsidiaries. Obviously, the disposition by this Court of the appeals in *Chicago Bridge & Iron Company v. Caterpillar Tractor Co.* (No. 81-349) and *Container Corporation of America v. Franchise Tax Board* (No. 81-523) will have a bearing on resolving the principles at issue in Firestone's own pending appeal.

Preliminary Statement.

This Court has not heretofore decided the precise issues involved in the instant appeal, namely, the validity, under the Commerce, Due Process and Supremacy Clauses of the United States Constitution, of worldwide combined reporting, wherein the incomes of a United States parent corporation and foreign subsidiaries which are incorporated and doing business wholly abroad are first combined together in a single tax base and then apportioned to the taxing state by some formulary method (typically, as in the case of California, by a three-factor formula consisting of property, payroll and sales.)

In *Bass, Ratcliff and Gretton v. State Tax Commission*, 266 U.S. 271, 69 L.Ed. 282 (1924), which is frequently

cited by state tax counsel as authorizing worldwide combined reporting, the question here at issue was neither addressed nor resolved. The taxpayer in *Bass* was a single corporate entity (a British-based manufacturer of ale) which did business *both* in Great Britain and, through various import agents, in the United States (in particular, the States of Illinois and New York.) This Court upheld the right of the State of New York to determine that portion of the taxpayer's business income earned within its borders by a formula method which was applied to a tax base consisting of the entire net profits of the taxpayer-corporation. In *Bass* a so-called "combined report" was not at issue, in view of the fact that it concerned only a *single* taxpayer which was itself amenable to the jurisdiction of the taxing state.

By contrast, worldwide combined reporting involves the inclusion in the tax base of a domestic taxpayer of the incomes of foreign corporations which have no nexus with the taxing state, do no business in the taxing state, and whose incomes are fully subject to tax by the foreign jurisdictions in which they are located.

ARGUMENT.

APPORTIONMENT BY FORMULA FOR STATE TAXATION PURPOSES OF A TAX BASE CONSISTING OF THE COMBINED INCOMES OF A UNITED STATES PARENT CORPORATION AND ITS FOREIGN SUBSIDIARIES INCORPORATED AND DOING BUSINESS EXCLUSIVELY ABROAD RESULTS IN GROSS DISTORTIONS OF INCOME IN FAVOR OF THE TAXING STATE IN VIOLATION OF THE DUE PROCESS CLAUSE AND IN DOUBLE TAXATION IN VIOLATION OF THE COMMERCE CLAUSE, AND INTERFERES WITH NATIONAL FOREIGN ECONOMIC POLICY OBJECTIVES IN VIOLATION OF THE SUPREMACY CLAUSE.

A. Primary Issue.

In this case the Court is asked to rule on the constitutionality of worldwide combined reporting. More specifically, the Court must determine whether the State of California may constitutionally apply its three-factor formula of property, payroll and sales to a tax base consisting of the combined incomes of a United States parent corporation and its separately incorporated foreign subsidiaries doing business wholly outside the United States, in order to apportion income for state taxation purposes. The relevant provisions of the United States Constitution include the Due Process Clause of the Fourteenth Amendment, the Commerce Clause insofar as it pertains both to interstate and to foreign commerce [Art. II, Sec. 2, cl. 2; Art. II, Sec. 3], and the Supremacy Clause [Art. VI, cl. 2].

B. Issue of First Impression.

This Court has not yet had occasion to pass upon the constitutional validity of worldwide combined reporting, in the face of a challenge to the fairness of a state apportion-

ment formula in a context where the pretax operating incomes of a United States parent corporation and its separately incorporated foreign subsidiaries have been combined in the apportionable tax base. In *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 63 L.Ed.2d 510 (1980), this Court held that dividend income *received in this country* by a parent corporation from its foreign subsidiaries could constitutionally be included in the tax base, absent an issue with respect to the "fairness" of the apportionment formula.

In *Mobil*, the taxpayer sought to raise an issue with respect to the "fairness" of the formula applied by the State of Vermont but the Court declined to reach it on the basis that it had not been presented to the state taxing authority, holding that "the evidence in the record is surely inadequate to evaluate . . . its potential implications." 63 L.Ed.2d, at p. 523, Footnote 15.

Worldwide combined reporting gives rise to a host of problems which are not present in a multistate context and which render it difficult, if not impossible, to apportion income fairly and equitably among taxing jurisdictions by a formulary method. Differing accounting systems, blocked currencies, devaluations, fluctuating exchange rates, wide variances in the risk factor, expropriations (both potential and actual), and foreign price and productivity controls give rise to irreconcilable problems in a worldwide context.

As noted by one commentator:

> ". . . the apportionment of income using a formula developed for use in the United States where business operations and the economy are somewhat uniform may not be a workable solution for companies operating under the laws of governments with entirely different business philosophies and practices and where the economies are substantially diverse." [Robert A.

Petersen, "California Franchise Tax: Combined Income Report Affects Foreign Companies", *The Journal of Taxation*, March 1976, p. 184].

C. The Due Process Clause.

Both the Due Process Clause and Commerce Clause of the federal constitution prohibit a state from taxing tangible or intangible property which is unconnected with the taxing state. In *Norfolk & Western Railway Company v. Missouri State Tax Commission*, 390 U.S. 317, 19 L.Ed.2d 1201 (1968), this Court held:

> "The taxation of property not located in the taxing State is constitutionally invalid, both because it imposes an illegitimate restraint on interstate commerce and because it denies to the taxpayer the process that is his due. A State will not be permitted, under the shelter of an imprecise allocation formula or by ignoring the peculiarities of a given enterprise, to 'project the taxing power of the state plainly beyond its borders.' " *Id.*, at p. 325. cf. *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978).

Nor, as a broad principle of constitutional law, may a state tax values earned outside its borders. *Connecticut General Life Insurance Co. v. Johnson*, 303 U.S. 77, 80-81, 82 L.Ed. 673 (1938)

The Due Process test is two-fold: it requires *first*, a minimal connection between the interstate (or multinational, as the case may be) activities and the taxing state and *second*, a "rational relationship" between the income attributed to the taxing state and the intrastate values of the enterprise which is taxed. *Mobil Oil Corp. v. Commissioner of Taxes*, 63 L.Ed.2d, at p. 520; *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978).

The "linchpin of apportionability" for state income taxation of an interstate (or multinational, as the case may

be) enterprise is the "unitary-business principle." *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S., at p. 439. For a "unitary" business to exist, however, it must be shown that contributions to income of the foreign subsidiaries sought to be unitized resulted from "functional integration, centralization of management and economies of scale." *Id.*, at p. 438. "Occasional oversight" with respect to matters affecting the capital structure, major debt, and dividends of majority-owned foreign subsidiaries does not, without more, satisfy either the "functional integration" or "centralized management" prerequisites. *F. W. Woolworth C[illegible] Tax. and Rev. Department of New Mexico*, Opinion p. 15 (Docket No. 80-1745, 6/29/82).

Functional integration is established where there is coordination and "controlled interaction" of the various operational functions of the business enterprise. *cf. Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207, 224, (1980); *Asarco Inc. v. Idaho State Tax Commission*, Opinion p. 12, footnote 13 (Docket No. 80-2015, 6/29/82). Where operational control is absent and the activities of the subsidiaries are, in a business and economic sense, "discrete business enterprises", there is no "unitary" relationship. *Asarco*, Opinion p. 21.

Mere "business advantage", or the fact that the business activities of the subsidiaries have "added to the riches" of the taxpayer corporation, are not dispositive of the unitary question. The proper focus is always on the "underlying unity or diversity" of the business enterprise, not whether "some economic benefit" has been derived by the taxpayer corporation. *Woolworth*, Opinion p. 9. Moreover, not the *potentiality for* but the *actuality of* operational control is dispositive. *Id.*, at p. 7.

The requisite connection must exist between the activities of the subsidiary to be unitized and the activities of the parent company taxpayer *in the taxing state*.

> "Where the business activities of the dividend payor have nothing to do with the activities of the recipient *in the taxing State*, due process considerations might well preclude apportionability, because there would be no underlying unitary business." *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S., at p. 441-442; *cf. Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S., at pp. 223-224; *Asarco Inc. v. Idaho State Tax Commission*, Opinion p. 21. *Emphasis supplied.*

The proper focus of inquiry is " 'whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state . . . .' *Wisconsin v. J. C. Penney Co.*, 311 U.S. 435, 444 (1940)." *Asarco*, Opinion p. 8. If the state tax in question does not bear the "necessary relationship" to the "opportunities, benefits or protection" conferred or afforded by the taxing state, the tax fails to meet established due process standards in that the state is attempting to reach "extraterritorial values." *Woolworth*, Opinion p. 17.

Finally, the Due Process inquiry must be made on a case-by-case basis.

> ". . . the application of the unitary-business principle requires in each case a careful examination both of the way in which the corporate enterprise is structured and operates, and of the relationship with the taxing state." *Asarco*, Opinion p. 20, footnote 22.

D. The Commerce Clause.

The jurisdictional tests under the Due Process and Commerce Clauses of the federal constitution are closely related. *National Bellas Hess v. Illinois*, 386 U.S. 753, 756, 18 L.Ed.2d 505 (1967).

The primary focus of inquiry under the Due Process Clause is whether the tax in practical operation has relation to the opportunities, benefits or protections conferred by the taxing state. Those requirements are satisfied if the tax is fairly apportioned to the commerce carried on within the state. *Norfolk & Western Railway Co. v. Missouri State Tax Commission*, 390 U.S., at p. 325, footnote 5.

Similarly, the focus under the Commerce Clause is to determine "what portion of an interstate organism may appropriately be attributed to each of the various states in which it functions." *Norfolk & Western Railway Co. v. Missouri State Tax Commission*, 390 U.S., at p. 325, footnote 5. The practical effect of a tax is measured against the requirements that it be *applied to an activity with a substantial nexus with the taxing state, be fairly apportioned*, be non-discriminatory, and *be fairly related to the services provided by the state. Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279, 51 L.Ed.2d 326, 331 (1977).

When a formula method is used to apportion income for state tax purposes, only "rough approximation" rather than absolute precision is required. *International Harvester Co. v. Evatt*, 329 U.S. 416, 422, 91 L.Ed. 390 (1947). Nevertheless, the amount of income apportioned to the taxing jurisdiction may not be out of "all reasonable proportion" to the business activities conducted within that jurisdiction. *Moorman Mfg. Co. v. Bair*, 437 U.S., at p. 274. A formula not arbitrary on its face or in its general operation may be unworkable or unfair when applied to a particular taxpayer under particular conditions. *Norfolk & Western Ry. Co. v. North Carolina*, 297 U.S. 682, 685, 80 L.Ed. 977, 980 (1936). If it appears that the formula burdens the taxpayer with a result grossly in excess of a more accurate apportionment, the formulary method unconstitutionally reaches extraterritorial values. *Id.*, at p. 686.

Where the foreign commerce clause is concerned, two additional considerations come into play: the "enhanced risk of multiple taxation" at the international level and the potential impairment of uniformity "in an area where federal uniformity is essential." *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 446, 60 L.Ed.2d 336 (1979). The second consideration pertains likewise to the Supremacy Clause of the federal constitution and in recognizes that matters affecting the foreign affairs and foreign economic policies of the United States are vested by the Constitution exclusively in the federal government. *United States v. Curtiss-Wright Export Corp.*, 299 U.S. 304, 316, 81 L.Ed. 255, 260 (1936).

Although formula apportionment may fairly reflect income in the context of a *multistate* business, when used in a worldwide context accompanied by combined reporting it produces results so far out of line with economic realities and with the prevailing method of taxation used by sovereign foreign nations that it clearly loses its value as a substitute for the "arms length" method of determining income for purposes of taxation. This Court said it best when it struck down an *ad valorem* property tax imposed by the State of Missouri on an interstate railroad operating within its borders:

> "The facts of life do not neatly lend themselves to the niceties of constitutionalism; but neither does the constitution tolerate any result, however distorted, just because it is the product of a convenient mathematical formula which, in most situations, may produce a tolerable product." *Norfolk & Western Ry. Co. v. Missouri Tax Comm.*, 390 U.S. at p. 327.

Thus, not only does the potential for interfering with the foreign economic policies and relationships of the United States exist when an individual state attempts to use world-

wide formulary apportionment, there is no authoritative tribunal (such as this Court in the context of a dispute between two or more states over the proper method of taxing the income of a multistate business) capable of insuring that the same income is not subject, by reason of diverse methodologies, to double taxation.

Indeed, the potential for, much less the actual occurrence of, international double taxation was sufficient for this Court to invalidate the tax at issue in *Japan Line, Ltd. v. County of Los Angeles*.

When the three-factor apportionment formula is applied to the pretax operating incomes of foreign subsidiaries in the context of the worldwide combined report, a gross misallocation of income inevitably results. Lower wage rates and property costs which have generally prevailed abroad since the end of World War II [Jt.App. 169, 182] cause the formula to *overstate* the amount of income earned in domestic state tax jurisdictions and to *understate* the income earned in foreign jurisdictions, in direct contrast to economic and financial realities. [Jt.App. 192]

One reason the three-factor formula is distortive in the international context is that it makes no accommodation for the risk factor associated with doing business abroad. There are three broad categories of risk at work in the foreign environment — "economic" (relating to marketplace considerations such as the size, strength and diversity of the foreign economy), "political" (pertaining to the type of government, commonality of institutions or lack thereof, and artificial impediments to economic equilibrium such as price controls, import restrictions and currency blockages) and "catastrophic" (pertaining to the threat of nationalization and expropriation which is an ever present concern in foreign jurisdictions.) [Jt.App. 155]

In the United States, deviations from the national average in profitability (rate of return), productivity, wage rates, and property values among different regions of the country tend to diminish over time due to the commonality of institutions (in the form of law, language and cultural heritage), homogeneity of the marketplace, and freedom of movement of capital and labor in this country. [Jt.App. 143] No such equilibrating forces are at work between sovereign foreign jurisdictions, with their own separate economic, political and nationalistic tendencies.

The increased risk factor associated with doing business in foreign jurisdictions translates in turn into higher rates of return (profitability) abroad "on the average and over the whole" as compared to the United States. [Jt.App. 147-148] The three-factor formula does not nor cannot take into account this risk factor in the apportionment of income for state taxation purposes.

The increased risks of doing business abroad likewise mandate a higher "hurdle" rate or minimum "expected" rate of return from foreign investments. [Jt.App. 135, 154] On the average and over the whole, actual (after-the-fact) rates of return abroad tend roughly to correlate with "expected" rates of return. If actual rates consistently exceeded expected rates, the perceived risk of doing business abroad would be lessened and more investment dollars would flow into the foreign area; conversely, if actual rates consistently fell short of expected rates, the "hurdle" rates would be driven higher.

This risk factor is intimately connected with the profitability of foreign investments and, by its inability to account for the risk factor phenomenon, the three-factor formula consistently *overstates* the amount of income attributable to a domestic state tax jurisdiction and *understates* the amount of income earned abroad.

Although the three-factor formula has no capacity to take the risk factor into account, the risk element *must* be taken into account when attempting to apportion by formula a tax base consisting in part of taxable income earned in foreign economies having a perceived risk factor which significantly exceeds that in the United States, and which carries with it higher actual rates of return or profitability.

The "reversal" phenomenon just described, wherein the formula allocates comparatively greater income to the place where costs are highest, rather than to where they are lowest, is illustrated in the three examples which follow. For purposes of the illustration it is assumed that a unitary business enterprise is comprised of a parent corporation doing business in California and a wholly-owned subsidiary which does business in Venezuela. Each company has one plant of approximately the same vintage (with an approximately equivalent net book value) and equal sales of 200 units per year, which produce $100 in net taxable income. The combined net income of the enterprise therefore is $200. In Example 1, all of the factors of the formula are equal and the productivity rate and operating expenses of the two companies are roughly equivalent. Applying the three-factor formula, 50% (or $100) of the combined taxable income of the enterprise is assigned to each jurisdiction (California and Venezuela), consistent with the books of the separate companies.

EXAMPLE 1

FACTOR	CALIFORNIA	VENEZUELA	TOTAL	CALIFORNIA FACTOR (% to Total)
Property	$ 50	$ 50	$100	.50
Payroll	50	50	100	.50
Sales	200	200	400	.50
		Average California Factor		.50

	CALIFORNIA		VENEZUELA	
SALES		$200		$200
(Less) Payroll		(50)		(50)
Operating Expenses				
Fixed Costs (Incl. depreciation, rent, etc.)	$25		$25	
Variable Costs	25	(50)	25	(50)
Taxable Income		$100		$100

Combined Taxable Income — $200

Assignment of Income Per 3-Factor Formula

$$\frac{(.50 + .50 + .50)}{(\quad 3 \quad)} \times \$200 = \$100 \text{ (Calif. Taxable Income)}$$

$$= \$100 \text{ (Venezuela Taxable Income)}$$

TAXABLE INCOME

	Per Books	% Total	Per Formula	% Total	% Distortion
Calif.	$100	50%	$100	50%	-0-
Venezuela	100	50%	100	50%	-0-

In Example 2, it is assumed that the prevailing wage rate at the California plant is ten times as great as that in Venezuela, while the payroll cost differential is offset only in part (by ½, or 50%) by the fact that the rate of productivity in California is twice that in Venezuela. All other factors remain constant.[1] Venezuelan profits increase from $100 to $140 in net taxable income; California remains at $100. The combined taxable income of the two companies is $240. The formula, however, assigns $146.40, or 61% of this

[1]In Example 2 it takes Venezuela $10 in payroll costs to produce $200 in sales (equivalent to sales in California), assuming a 1:10 ratio of Venezuela to California payroll (California payroll remains constant at 50), offset in part by a favorable rate of productivity in California of 2:1. But for the productivity offset, $10 in Venezuela payroll would have produced $400 in Venezuela sales (or, stated in another way, it would have taken $5 in Venezuela payroll to produce $200 in sales equivalent to California).

combined profit, to the State of California, whereas in economic reality only $100, or 41.67%, was actually derived there. This distortion in favor of California as a result of the formula is due solely to the differential in wage rates. Lower wage rates abroad inevitably result in a distortion of income in favor of California, when the formula is applied to the combined incomes of a domestic parent corporation and a foreign subsidiary corporation.

EXAMPLE 2

FACTOR	CALIFORNIA	VENEZUELA	TOTAL	CALIFORNIA FACTOR (% to Total)
Property	$ 50	$ 50	$100	.50
Payroll	50	10	60	.83
Sales	200	200	400	.50
		Average California Factor		.61

	CALIFORNIA		VENEZUELA	
SALES		$200		$200
(Less) Payroll		(50)		(10)
Operating Expenses				
Fixed Costs	$25		$25	
Variable Costs	25	(50)	25	(50)
Taxable Income		$100		$140

Combined Taxable Income — $240

Assignment of Income Per 3-Factor Formula

$$\frac{(.50 + .83 + .50)}{(\quad 3 \quad)} \times \$240 = \$146.40 \text{ (Calif. Taxable Income)}$$

$$= \$93.60 \text{ (Venezuela Taxable Income)}$$

TAXABLE INCOME

	Per Books	% Total	Per Formula	% Total	% Distortion
Calif.	$100	41.67%	$146.40	61%	46.40%
Venezuela	140	58.33%	93.60	39%	(33%)

Thus, whereas the Venezuelan books reflect a profit of $140, the formula assigns only $93.60 to Venezuela, which is only 67% of the profits actually earned there and which were subject to tax by Venezuela. The formula *overstates* the profit to California and *understates* the profit to the foreign country. This is exactly the opposite result one would expect in view of the lower wage rates prevailing abroad.

If the facts of the hypothetical are further modified to reflect a lower investment base in Venezuela as well as the payroll differential introduced in Example 2, the distortion in favor of California is even more emphatic, as illustrated by Example 3.

EXAMPLE 3

FACTOR	CALIFORNIA	VENEZUELA	TOTAL	CALIFORNIA FACTOR (% to Total)
Property	$ 50	$ 25	$ 75	.67
Payroll	50	10	60	.83
Sales	200	200	400	.50
		Average California Factor		.67

	CALIFORNIA		VENEZUELA	
SALES		$200		$200
(Less) Payroll		(50)		(10)
Operating Expenses				
Fixed Costs	$25		$12.50	
Variable Costs	25	(50)	25.00	(37.50)
Taxable Income		$100		$152.50

Combined Taxable Income — $252.50

Assignment of Income Per 3-Factor Formula

$$\frac{(.67 + .83 + .50)}{(\quad 3 \quad)} \times \$252.50 = \$169.18 \text{ (Calif. Taxable Income)}$$

$$= \$83.32 \text{ (Venezuela Taxable Income)}$$

TAXABLE INCOME

	Per Books	% Total	Per Formula	% Total	% Distortion
Calif.	$100.00	39.60%	$169.18	67%	69.18%
Venezuela	152.50	60.40%	83.32	33%	(45%)

In Example 3, the profit earned in California remains constant, since there was no change in any of the California factors from the previous examples. The Venezuelan plant is included in the denominator of the property factor at a lower value, reflective of the lower acquisition costs (hence a lower investment base or "net book value") generally prevailing abroad during the past several decades. The payroll factor is the same as in Example 2. The reduced investment base is reflected in reduced fixed costs which, in turn, increase the taxable profits of Venezuela from $140 to $152.50. The combined taxable income of the enterprise, or $252.50, is allocated by formula $169.18 to California (as compared to a book profit of $100) and $83.32 to Venezuela (as compared to a book profit of $152.50.) The formula thus allocates 67% of the combined income to California, whereas in economic reality only 39.6% thereof was derived there. Conversely, the formula allocates 33% of the combined income to Venezuela, whereas 60.4% thereof was actually derived in and was subject to tax by Venezuela. This 69% distortion in favor of California results from the fact that, when the investment base and payroll costs are lower abroad than in California, the denominators of the formula factors are smaller than they would have been had such costs been relatively equal, thereby increasing California's percentage of both the payroll and property factors of the combined group. Inevitably, the formula will assign a greater portion of the combined profits to California since California's combined factor in Example 3 is larger

than in either of the previous two examples. In economic reality, however, it was only because of the fact that property and payroll costs were lower abroad that the combined group was able to realize greater profits in Example 3. Logically, one would expect that the taxable profits of the foreign company would be greater than those of the California company, based on equivalent sales, since the costs abroad are markedly lower than the costs in California. This is plainly not the case, when the formula approach is used. Instead of recognizing the lower cost patterns abroad and the greater profitability of foreign companies, the formula overstates the portion of profit attributable to California and understates it to the foreign country.

E. The Supremacy Clause.

Unquestionably, the preferred method for allocating profits and income earned across international borders is that of "arm's length" separate accounting. Indeed, "arm's length" separate accounting is almost unanimous in its use by the foreign economies in the Free World. It has been referred to as the "internationally accepted norm"[2] and it underlies the Model Double Taxation Treaty of the Organization for Economic Cooperation and Development ("OECD").[3] The "arm's length" method appears in the first income tax convention to which the United States was a party (Income Tax Convention, April 27, 1932, United States-France, Article IV, 49 Stat. 3145, TS No. 885) and

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[2]"*Tax Treaties with the United Kingdom, the Republic of Korea and the Republic of the Philippines:*" *Hearings before the Senate Comm. on Foreign Relations, 95th Cong.*, 1st Sess. 33 (1977) (Statement of Laurence N. Woodworth, Assistant Secretary of the Treasury).

[3]Article 7, Sec. 2; Article 9, Sec. 1.

it has been the basis for all tax treaties ratified since by the federal government.[4]

In its January, 1979 report entitled "Transfer Pricing and Multinational Enterprises" (which was subsequently adopted by the Council of the OECD in May, 1979), the Fiscal Affairs Committee of OECD roundly condemned so-called "global" methods of profit allocation, such as worldwide formulary apportionment, in favor of the "arm's length" principle. The report stated:

> "Proposals for radical reformulations of the approach to intragroup transfer pricing which would move away from the arm's length approach towards so-called global or direct methods of profit allocation, or towards fixing transfer prices by reference to predetermined formulae for allocating profits between affiliates, *are not endorsed* in this report. *The use of such alternatives to the arm's length principle is incompatible in fact with articles 7 and 9 of the OECD Model Double Taxation Convention*. . . .
>
> Another major disadvantage of any attempt to use such global methods of profit allocation as an alternative to the arm's length principle is that their uncoordinated use by the tax authorities of several countries would involve the danger that, overall, the [multinational enterprise] affected would suffer double taxation of its profits." [*"Transfer Pricing and Multinational Enterprises," Report of the OECD Committee on Fiscal Affairs* (Paris, 1979), pp. 14 & 15] Emphasis supplied.

The widespread consensus in favor of the arm's length method is indicated by the following extract from the same report:

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[4]Cf. U.S.-France, 7/25/39, Art. 3, 125 UNTS 259; U.S.-New Zealand, 3/16/48, Art. 3, Par. 1, 2 UST 2378; U.S.-Pakistan, 7/1/57, Art. 3, Par. 2, 10 UST 984.

> ". . . it may be noted that the arm's length approach, which underlies this report, has also been endorsed by the United Nations Group of Experts on Tax Treaties between Developed and Developing Countries, and that there is a broad consensus among governments of developed and developing countries and [multinational enterprises] that arm's length pricing is an appropriate approach to adopt in arriving at profits for tax purposes." [*"Transfer Pricing and Multinational Enterprises,"* pp. 8 & 9]

Senator Howard H. Baker, Jr. (R., Tennessee) aptly noted the potentially adverse ramifications, at the international level, should any state of the United States be permitted to use worldwide formulary apportionment, in views expressed in a Senate Committee Report on the proposed 1975 Income Tax Convention between Great Britain and the United States:

> "The precedent of unitary taxation on a worldwide combined reporting basis cannot be established by this country without probable retaliation by scores of countries around the world whose ambition may extend to those profits of U. S. multinational corporations generated beyond their jurisdictional limits." [Report of the Committee on Foreign Relations of the United States Senate (Ex. Rpt. 96-5, June 15, 1979), p. 16.]

Precisely this same concern was articulated by this Court in *Japan Line*, in addressing the impact which a novel state tax could have at the international level:

> "If a novel state tax creates an asymmetry in the international tax structure, foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdictions. Such retaliation of necessity would be directed at American transportation equipment in general, not just that of the taxing State, so that the Nation as a whole

would suffer." *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S., at page 450.[5]

In testimony before the United States Senate Foreign Relations Committee in July, 1977, former Assistant Secretary of the Treasury Laurence N. Woodworth stated that the formulary apportionment method in an international context generates complaints from treaty signatories, varies from the internationally accepted arm's length practice and carries with it the potential for extraterritorial taxation.[6]

Were the State of California permitted to use its formulary apportionment method as against a tax base consisting of the *pretax incomes* of appellant and its foreign subsidiaries it would impact negatively on the foreign economic policies of the United States in yet another respect.

In this respect it was the express policy of the United States Government during the period in issue (roughly 1963 through 1965) to promote, through foreign investment, the economic growth and industrial development of the undrveloped and underdeveloped areas of the Free World. This

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[5]There is and can be, of course, no direct relationship between a state of the United States and a foreign corporation having no nexus or contact with the state, or between the state and a foreign taxing authority. Hence, foreign corporations in which a U.S. corporation has invested have no protection against the arbitrary levy of corporate income tax by a state under the unitary tax method or any other method. [Blough and Wagner, "U.S. Income Tax Treaty with the United Kingdom: Evaluation of Its Benefits to the United States Including Reasons for Approving the Constraints It Places on State Use of Unitary Apportionment", U.S. Department of Commerce: Foreign Business Practice Division-Office of International Finance and Investment Industry and Trade Administration (April 19, 1979), page 16.]

[6][*"Tax Treaties with the United Kingdom, the Republic of Korea and the Republic of the Philippines:" Hearings Before the Senate Committee on Foreign Relations, 95th Congress, 1st Sess., page 33 (1977)*]

policy was reflected not only in various federal statutes[7] but in treaties[8] as well.

Appellee insists that California does not impose a direct tax upon the incomes of foreign based corporations. The practical effect, however, of including the incomes of appellant's foreign subsidiaries in its apportionable base clearly taxes such profits. As noted by Mr. Woodworth at the 1977 Congressional hearings considering the proposed United States/United Kingdom Treaty:

> "Implicit in the unitary system is the assumption that profit rates in different units of a corporate family, engaged in different activities and in different locations, are always the same. This is clearly not the case. And when it is not the case, the unitary system will misallocate income. *Whenever profit rates are higher in foreign affiliates than in domestic activities, the unitary system allocates too much income to the domestic member or members of the group. The result is tan-*

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[7]In the *Foreign Assistance Act of 1961*, the United States Congress declared it to be the official policy of the United States to:

> "(1) . . . encourage the efforts of other countries to increase the flow of international trade, to foster private initiative and competition, . . .; and *to encourage the contribution of United States enterprise towards economic strength of less developed friendly countries, through private trade and investment abroad,* . . ." [75 Stats. 424, 22 *U.S.C.* §2351] Emphasis supplied.

[8]During the period in issue there were in force and effect a number of "investment guarantee" treaties [cf: U.S.-Argentina 12/5/61, 12 U.S.T. 955; U.S.-Italy 10/18/57, 8 U.S.T. 1881; U.S.-Mexico 4/6/54, 5 U.S.T. 1373] pursuant to 22 *U.S.C.* §2181 as well as "Technical Cooperation" treaties pursuant to 22 *U.S.C.* §2161 between the United States and developing nations. Typical of the former group is the treaty between the United States and Argentina entitled "Guaranty of Private Investment", which provides:

> "Recognizing that the investment in Argentina of private capital originating in the United States of America can stimulate the economy of Argentina, thereby effecting a rise in its production and a greater exchange in trade between the Argentine Republic and the United States of America; [the United States agrees to confer regarding investment guarantees]."

tamount to taxation by a state government of the foreign income of a foreign corporation."[9]

Imposition by the State of California of an increased incidence of tax on a United States corporation by reason of its having invested in foreign subsidiaries doing business in underdeveloped areas of the Free World clearly discourages such foreign investment by United States corporations, interferes with established national policy, and unconstitutionally intrudes upon the federal power to deal with foreign affairs. By subjecting appellant to an increased tax liability as a result of its investments in foreign companies, the State of California creates a substantial disincentive to further investment abroad. Mr. Woodworth recognized the inhibitive effect which taxes have on the free flow of capital and technology to foreign countries when he stated:

> ". . . among the major impediments to freer capital and technology flows are the rules of national tax systems and their interaction with the systems of other countries.
>
> ". . . one of our fundamental objectives is to minimize impediments to free international flows of capital and technology[.] . . ."[10]

Under the federal constitution responsibility for the conduct of national foreign policy is entrusted solely to the federal government [*U.S.* Const. Art. II §3; *Zschernig v. Miller*, 389 U.S. 429, 443, 19 L.Ed.2d 683, 693 (1968)] as is the treaty-making power [*U.S.* Const. Art. II §2 Clause 2]. Under the Supremacy Clause [*U.S.* Const. Art. VI clause

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[9] "*Tax Treaties with the United Kingdom, the Republic of Korea and the Republic of the Philippines:*" *Hearings Before the Senate Committee on Foreign Relations, 95th Congress, 1st Session p. 34 (1977) emphasis supplied.*

[10] "*Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines:*" *Hearings Before the Senate Committee on Foreign Relations, 95th Congress, 1st Session p. 28 (1977).*

2] the power of the federal government over foreign policy is exclusive, plenary, and not subject to interference or curtailment by the states. *United States v. Curtiss-Wright Export Corp.*, 299 U.S. 304, 315, 81 L.Ed. 255, 260-261 (1936); *United States v. Belmont*, 301 U.S. 324, 330, 81 L.Ed. 1134 (1937). Issues relating to the expansion or contraction of foreign trade and the degree to which the United States and its citizens will assist in the development of industry abroad are policies that are national in scope and must be left to the federal government. Assertion of the California formulary method in the area of foreign economic policy has clear potential for disruption and is an obvious unconstitutional intrusion into this exclusive federal domain.

Conclusion.

Apportionment by formula of the combined incomes of a United States parent corporation and foreign subsidiaries incorporated and doing business exclusively abroad, on a worldwide combined report basis, contravenes both the Commerce Clause and the Supremacy Clause of the federal constitution. In addition, where as here the record has shown that such formulary method grossly distorts the attribution of income for state tax purposes, the Due Process Clause is likewise violated. Because of this, the judgment of the California Court of Appeal upholding the application of a three-factor apportionment formula to a tax base consisting

of the incomes of appellant Container Corporation of America and its majority-owned foreign subsidiaries must be reversed.

Dated: July 29, 1982.

Respectfully submitted,

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